No. 4048

In The United States Circuit Court of Appeals

For The Ninth Circuit

FIDELITY & DEPOSIT COMPANY OF MARYLAND, a corporation,

Plaintiff in Error,

vs.

JOHN P. DUKE, Supervisor of Banking of the State of Washington, liquidating the KELSO STATE BANK,

Defendant in Error.

UPON WRIT OF ERROR TO THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF WASHINGTON, SOUTHERN DIVISION

HON. EDWARD E. CUSHMAN, *District Judge.*

REPLY BRIEF OF PLAINFIFF IN ERROR

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THOMAS E. DAVIS,
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REPLY BRIEF OF PLAINTIFF IN ERROR

SET OFF

Defendant in error has cited many authorities on this question which are not in point. The case of *Yardley v. Philler*, 17 Sup. Ct. Rep. 835, cited on Page 8 of the brief, is based upon the rule that the debtor of an insolvent bank cannot set off against his debt a claim assigned to him after its

insolvency. As pointed out at Pages 18 and 19 of the brief of plaintiff in error, the set off is not based upon any claim assigned to plaintiff in error after insolvency, but is based upon the right of a surety which has paid an obligation for its principal on account of a bond executed prior to insolvency. The quotation from 34 Cyc. 678 on Page 9 of said brief refers to recoupment and not to set off. The definition of recoupment and set off, as given in 34 Cyc. on Pages 623 and 625, clearly distinguishes the rule cited from the case at bar.

Following the quotation given in said brief the rule relating to a set-off is stated in 34 Cyc. 680, as follows:

> "Although it has been held under some statutes, particularly the earlier ones, that the right of set-off is limited to debts or demands growing out of a transaction independent of the contract sued on, the very general construction of statutes of set-off now is that the right of set-off extends to all mutual debts and demands between the parties, whether independent or unconnected with plaintiff's cause of action, or springing from and connected with the contractual transaction upon which plaintiff's claim is based."

The statutes of the state of Washington, cited in the brief of plaintiff in error on Pages 16 to 18, expressly permit a defendant to set off, in an action arising on contract, any other action arising on contract and existing at the commencement of the

action. Relative to the quotation from 34 Cyc. 690, on Page 10 of said brief, the author is referring to reconvention and not to set-off.

With reference to the quotation from 34 Cyc. 696 relative to unliquidated damages, the plaintiff in error is not attempting to set off any unliquidated damages in the instant case. Its damages were fully liquidated at the instant the bank closed and the amount was definitely fixed.

Some argument is made on Pages 10 to 13 of said brief that plaintiff's action is for damages and sounds in tort. The first case cited on Page 11 of said brief merely states that the action is for damages for breach of the conditions of the bond; that is, it is an action for breach of the contract. There is nothing in said case holding that the action is not an action *ex-contractu.* The cases on Pages 11 and 12, holding that the bond is collateral security, do not in any way hold that an action on the bond is not an action *ex-contractu.* The Washington cases cited on Pages 11 and 12 of said brief were all cases in which the statute of limitations was involved, and the Court held that the bond, being in the nature of collateral security for the performance of an obligation by the principal, a discharge of the principal by reason of the statute of limitations discharged the surety and barred an action on the collateral security contract.

We call the Court's attention to the cases cited on Pages 29 and 30 of our former brief.

On Page 13 of said brief the statement is made

that plaintiff in error claims that the set-off in this case is statutory and not equitable. No such contention is made in our former brief, and we particularly refer to Page 28 of said brief wherein we stated that both by reason of the statutes of the state of Washington, and also in equity, the set-off should be allowed. We cited the Act of March 3rd, 1915, Section 274 (b), which makes it immaterial whether the set-off is of a legal or equitable nature. In either event the same can be pleaded in the Federal Courts in an action at law.

On Page 14 of said brief counsel states, with reference to the great number of decisions cited in our former brief relative to right of set-off, that he will not undertake to review them in detail. No distinction is pointed out between the cases cited and the case at bar, and we confidently assert that there is no distinction. Those cases hold that a surety's right upon the payment of an obligation of its principal relates back to the execution of the bond, and that the surety is to be deemed a creditor of the principal from the time of the execution of the bond, or, at the latest, from the time of the default of the principal. It was therefore, in the instant case, a creditor of the Kelso State Bank on account of the transactions arising out of the depository bond, at the latest, the instant the bank closed. Whether it could have brought any action against the bank until it had reimbursed the County Treasurer, is a question which is not involved, because, at the most, all that could be said would

be that the debt from the bank to it was not due until it had paid its obligation to the County Treasurer. The rule applicable to such cases is clearly stated in 34 Cyc. 674, as follows:

> "* * * but where plaintiff is insolvent defendant may set off in equity a demand, although not yet due or payable, and he may set off against a matured debt assigned to plaintiff a debt not due at the time of the assignment, the assignor being insolvent."

In reference to the case of *U. S. Fidelity & Guaranty Co. v. Maxwell* (Ark.) 237 S. W. 708, counsel states on Page 14 of his brief that the bonding company became surety for a depositor in the bank insuring the depositor against loss. This statement is not in accordance with the facts as stated in the decision in that case. The distinguishing feature in that case was that the bonding company had not executed a bond as surety, but had guaranteed the payment of the deposits in the bank by an instrument to which the bank was not a party, and that there was no privity between the bank and the bonding company. In other words, there was no relation of principal and surety existing, but the U. S. Fidelity & Guaranty Company had executed a policy of insurance insuring the depositor against loss, rather than a surety bond such as was executed in the instant case.

The distinction between these two cases is apparent. If an insurance company executed a policy of insurance covering an automobile, and the same

is damaged by a third party, the third party does not become the debtor of the insurance company unless and until the insurance company has paid the owner of the automobile for the damage and taken an assignment, there being no privity between the third party who injured the automobile and the insurance company. In the case of a surety bond, such as was executed in favor of the County Treasurer in this case, there was privity between the Kelso State Bank and the plaintiff in error, both being parties to that bond, the one principal and the other surety.

On Pages 16 and 17 of said brief counsel calls attention to the trust fund doctrine which prohibits an insolvent corporation from preferring one creditor at the expense of another. There is no question of preference in this case. All that the creditors of the Kelso State Bank are entitled to receive is their just portion of the assets of that bank. In a few early cases depositors in an insolvent bank were not permitted to set off their deposits against the amounts which they owed the the bank, on the theory that such a set-off would give a preference in violation of the statutes forbidding preference and requiring a ratable distribution of the assets. These decisions were based upon the erroneous assumption that the assets of a bank consisted of all amounts owing to the bank, regardless of whether the debtor had a claim against the bank. However, it is now well settled that the *assets* which the receiver is bound to distribute

ratably consist of the balance due to the bank from its debtors, after allowing such debtors to set off the amount of their deposits or other claims against the bank.

Scott v. Armstrong, 146 U. S. 499, 36 U. S. (L. Ed.) 1059.

Ann. Cas. 1917, C 1190 and cases cited.

In the case of *Scott v. Armstrong*, *supra*, the Supreme Court of the United States said:

> "* * * Where a set-off is otherwise valid it is not perceived how its allowance can be considered a preference, and it is clear that it is only the balance, if any, after the set-off is deducted, which can justly be held to form part of the assets of the insolvent. The requirement as to ratable dividends is to make them from what belongs to the bank, and that which at the time of the insolvency belongs of right to the debtor does not belong to the bank."

On Page 18 of said brief an analogy is attempted to be drawn between the amount owing on the cashier's bond and the liability of a stockholder, and the assertion is made that the sum due on the bond to the bank is a trust fund for the benefit of all of the depositors. It is true that the Courts have held that, in an action by a receiver of an insolvent bank against its stockholders to recover on their liability as stockholders or subscribers to the capital stock, the stockholders are not entitled to set off any debt which the corporation owes them.

These decisions are based upon the rule that the capital stock of a corporation and the stockholders' liability are trust funds for the benefit of all creditors, and that the only way such liability can be satisfied is by payment in cash. In the case of the capital stock of a corporation, or the stockholders' liability, the creditors have a right to rely upon the entire capital stock as an asset of the corporation, and in case of banks they have a right to rely upon the liability of the stockholders. These are funds which cannot be impaired or distributed otherwise than equally among the creditors in case of insolvency proceedings. They are assets which are capable of exact computation at all times, and because of their trust character the Courts will not permit set-offs. The obligation of the plaintiff in error, if any, is an obligation arising out of contract. If anything has become due on it, it is the bank's debtor, to that extent, in the same manner as if it had borrowed money from the bank and given its promissory note. In the absence of dishonesty on the part of the cashier causing loss to the bank, it was no asset at all. It was not something that the creditors could depend upon being paid in cash, in any and all events, in a certain definite amount. If the cashier was dishonest and his dishonesty has caused loss to the bank under the terms and conditions of the bond, plaintiff in error became indebted to the bank to the extent of such loss, but that indebtedness is no more in the nature of a trust fund than the indebtedness of

any other person to said bank. No cases have been cited by counsel holding that the amount due on the bond is a trust fund, and we confidently assert that there are no cases so holding.

On Page 20 of his brief counsel discusses the election of remedies, and contends that the presentation of a claim by plaintiff in error on account of having paid the County Treasurer on the depository bond constituted an election of remedies barring it from asserting the amount due from the bank as a set-off in the present action. None of the cases cited are in point and we do not believe that the law requires a party having a claim against a bank to refrain from presenting such claim until after the time for presentation of claims has expired, for fear that the officer liquidating the bank might sue him on another obligation. There is nothing inconsistent between presenting a claim and asserting the same as a set-off. The rule quoted from Corpus Juris on Page 20 of said brief refers to estates of insolvents and decedents, and states that the presentation of a claim will prevent the prosecution of an action or suit based upon an inconsistent remedial right. None of the cases cited hold that the presentation of such claim is inconsistent with setting off the same in case an action is brought by a receiver or administrator.

In the case of *Fishburne v. Merchants Bank of Port Townsend*, 42 Wash. 473, 85 Pac. 38, the Supreme Court of the State of Washington held that the presenting of a claim to an executor or

administrator is not a prerequisite to asserting it as a set-off, but that the claimants right was limited to the extinguishment of the debt sued on if no claims had been presented against the estate. If the claim had been presented against the estate, the Court would, in addition to allowing the set-off, have given the defendant judgment for the balance remaining due it after deducting the amount which it owed plaintiff. This case was followed and is cited with approval and quoted from in *Re Adler's Estate*, 116 Wash. 484, 199 Pac. 762.

Common Law Bonds

On Pages 36 to 46 of said brief it is contended by defendant in error that the bonds in this case were statutory bonds. In the cases cited by defendant in error the bonds contained the provisions of the statute, and were given in an attempt to comply with the statute; while in this case, as counsel states on Page 43 of their brief, "it is true that it does not appear that the bond in this case was furnished directly in pursuance of the statute." Furthermore the bonds do not contain the conditions required by statute; were not pleaded as statutory bonds; are not void for want of form or substance, recital or condition; are good and valid common law bonds; and no reformation of the same has been asked. The complaint in this action is based upon the obligations of the bonds as written, and the contention that the same are statutory

bonds was a mere afterthought on the part of counsel for defendant in error.

Whatever the rule may be in other states, the Supreme Court of the State of Washington has expressly decided that if the bonds do not meet the requirements of the statute they are not statutory bonds, but common law bonds.

> *Smith v. Tukwila*, 118 Wash. 266, 203 Pac. 369.

The bond in question in the case last above cited was a bond given pursuant to Section 1159 *et seq.* Remington's Code, which section reads, in part, as follows:

> "Whenever any board, council, commission, trustees or body acting for the state or any county or municipality or any public body shall contract with any person or corporation to do any work for the state * * * such board, council, commission, trustees or body *shall require* the person or persons with whom such contract is made to execute and deliver to such board, council, commission, trustees or body a good and sufficient bond * * *"

The conditions of such bond are expressly set out. In discussing this case the Supreme Court said:

> "The bond here does not meet any of the requirements of the statutes. It had but one surety and was not for the full amount of the contract price. The bond is, therefore, not a statutory bond, and the question is whether it is good as a common law bond. We take it

that the statutes cited do not compel the municipality to exact the bond there provided for, but that it may elect to proceed with the work under other guarantees of its performance, taking the risk incident to failure to secure the statutory bond. There is no question that the appellant accepted the bond in good faith at the time it entered into the contract, and, so long as the law does not provide that the municipality shall not take a bond other than that provided for in the statute, or that such bond, if taken, shall be without effect, we are constrained to hold that the bondsman will be liable as upon the common law bond. *Sears v. Williams*, 9 Wash. 428, 37 Pac. 665, 38 Pac. 135, 39 Pac. 280; *Pacific Bridge Co. v. United States F. & G. Co.*, 33 Wash. 47, 73 Pac. 772."

It will be noticed that the statute in the above case expressly provides that the board, council, commission, etc., *shall require a bond.* The statute further contains the provisions of the bond and the terms of the same.

Paraphrasing the above language, it might be stated in the instant case that the statutes would not compel the bank to exact the bond there provided for, but that it may elect to continue the cashier in office under other guarantees, taking the risk incident to failure to secure the statutory bond. Furthermore, there is no statute which prohibits the bank from taking other or additional bonds

covering a cashier, than the bonds provided by statute. The bond not having been given pursuant to statute, and not containing the conditions required by statute, plaintiff in error could very well have assumed, granting that it was familiar with the statute (of which there is no evidence), that the bond which it continued in force after the passage of the statute, and the bond which it executed after the passage of such statute, were other or additional bonds than those required by statute.

Kelso Farm Company Notes

On Page 33 of the brief of defendant in error the statement is made that the $6,000 referred to in a resolution of January 11th, 1921, which was a resolution by the board of directors of the Kelso State Bank authorizing a loan to F. L. Stewart in the amount of $6,000, was in the claim presented to plaintiff in error, but was not pressed because of the resolution of the board of directors, and that this resolution had nothing whatever to do with the loan to the Kelso Farm Company, but referred entirely to another matter.

We beg to call the Court's attention to the $6,000 referred to as being in the claim presented, which is the last item in the claim, Exhibit "16," and to the minutes of December, 1920, Exhibit "2-A." Said minutes read as follows:

> "Two principal matters were up for discussion, namely the suggestion of the bank examiner that $6,000 of the Max Johnson paper

be retired. A resolution of the board of directors was passed as follows:

'Resolved, that the board of directors of the Kelso State Bank hereby authorize F. L. Stewart to retire $6,000 of the Max Johnson paper, giving his note temporarily for the purpose until he is able to take care of the item in cash. Letter of authorization of George L. Marsh is attached to this resolution. This resolution was passed unanimously.' "

The claim presented and the allegation of the complaint, Record 12, show that Stewart executed a note on December 18, 1920, to the Kelso State Bank, in the sum of $6,000. This was the note that was used to retire worthless paper held by the bank and signed by Max Johnson, and this was the note that counsel claims was not pressed because of the resolution of the board of directors of January 11th, 1921. A reference to the resolution of January 11th, 1921, shows that a loan to Mr. Stewart was authorized in the sum of $6,000. Certainly counsel does not contend that the placing of his note in the bank to retire worthless paper held by the bank was a loan to the cashier. Such an action does not meet the definition of a loan—either in its popular or technical sense. This note was placed in the bank to retire worthless paper held by the bank in accordance with the written guaranty which Mr. Stewart had executed on May 26th, 1919, which guaranty is contained in the minutes as part

of Exhibit "2-A," whereby Stewart guaranteed the paper held by the bank to the extent of $50,000.

Under the statutes of the State of Washington, making it a felony for an officer of a bank to borrow money from the bank without having previously been authorized so to do by a resolution of the board of directors, and the decisions in the cases of *State v. Larsen*, 119 Wash. 259, 205 Pac. 373, and *State v. Lindberg*, 25 Wash. Dec. 128, a resolution passed on January 11th, 1921, authorizing a loan which had been made on December 18, 1920, would have been an idle ceremony, and would not have protected either the cashier or other officers of the bank.

No other loan having been made to Stewart after the resolution of January 11th, 1921, except the two Kelso Farm Loans, the Court cannot escape the conclusion that these loans were authorized.

The various other questions raised in the brief of defendant in error have been fully covered in our former brief.

Respectfully submitted,

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